

August 2, 1999

Barbara A. Schermerhorn
Clerk

NOT FOR PUBLICATION
**UNITED STATES BANKRUPTCY APPELLATE PANEL
OF THE TENTH CIRCUIT**

IN RE JOHN LAVAR FRANCKS and
SUE ANN FRANCKS,

Debtors.

BAP No. UT-98-064

FIRST SECURITY BANK, N.A.,

Appellant,

Bankr. No. 98-22451
Chapter 12

v.

JOHN LAVAR FRANCKS, SUE
ANN FRANCKS, and DUANE H.
GILLMAN,

Appellees.

ORDER AND JUDGMENT*

Appeal from the United States Bankruptcy Court
for the District of Utah

Before BOHANON, ROBINSON, and CORNISH, Bankruptcy Judges.

ROBINSON, Bankruptcy Judge.

The Court has before it for review an order confirming the Chapter 12 Plan filed by John LaVar Francks and Sue Ann Francks (the Debtors). For the reasons set forth below, we reverse the bankruptcy court's decision and remand for proceedings in accordance with this order and judgment.

I. Background.

John LaVar Francks has been a turkey farmer for over 40 years. The

* This order and judgment has no precedential value and may not be cited, except for the purposes of establishing the doctrines of law of the case, res judicata, or collateral estoppel. 10th Cir. BAP L.R. 8010-2.

Debtors own 51% of John V. Francks Turkey Co., Inc. (the "farm corporation"), which is the debtor in a separate Chapter 12 proceeding. The Debtors' son, Matthew, owns the remaining 49% of the farm corporation. The farm corporation, also known as White Acres Turkey Ranch, is a turkey producer under contract with Moroni Feed Company. John Francks is president of the farm corporation and its employee.

The three years preceding the bankruptcy filing were financially difficult for the Debtors. Turkey prices were down and their flock was struck by an outbreak of avian flu. In 1996, the Debtors switched from being cash growers to contract growers and reduced their expenses by cutting the work force to John Francks and his son, Matthew. The farm corporation operated under an "80/20" revenue share agreement with Moroni Feed Company; John Francks drew his salary from the dividends paid to the farm corporation.

The Debtors' schedules indicate that in 1996, the Debtors pledged 30 shares of water stock to Moroni Feed Credit Union in exchange for a loan of \$27,293.00; the Debtors testified they used the loan proceeds for living expenses during 1997. John Francks testified that he decided not to draw any salary from the farm corporation in 1997, and the Debtors' schedules reflect no farm income in that year. However, the schedules list the \$27,293.00 loan from Moroni Feed Credit Union as income from their farming operation; the loan is also listed as a secured claim in the same amount under Schedule D. Sue Ann Francks started a catering business in 1997 that earned \$2,000.00.

First Security Bank (the Bank) has a secured claim of \$222,087 and an unsecured claim of \$969,985.50. The Debtors surrendered their vehicle to the Bank and will make a \$50,000 payment on the secured claim; the payment will be borrowed against their life insurance policy. The Debtors' Plan does not provide for any further payments to the Bank, as the Bank's claim is to be paid in full by

the confirmed Chapter 12 Plan of the farm corporation. The Bank moved to dismiss the case and objected to confirmation of the Plan on five grounds: 1) the Debtors were not eligible for Chapter 12 relief; 2) the Plan did not satisfy 11 U.S.C. § 1225(a)(5)(B)(ii)¹; 3) the Plan violated the best interest test set forth in § 1225(a)(4); 4) the Plan was not feasible; and 5) the Plan was not filed in good faith.

The bankruptcy court heard two days of evidence on the confirmation issues. In addition to their testimony, the Debtors presented testimony of Matthew Francks and David Bailey, president of Moroni Feed Co. The Bank presented testimony of two of its officers. Based on the evidence, the bankruptcy court denied the motion to dismiss and confirmed the Plan.² This appeal followed.

II. Appellate Jurisdiction.

This Court, with the consent of the parties, has jurisdiction to hear timely-filed appeals from "final judgments, orders, and decrees" of bankruptcy courts within the Tenth Circuit. 28 U.S.C. § 158(a)(1), (b)(1), and (c)(1). Under this standard, we have jurisdiction over this appeal. The parties have consented to this Court's jurisdiction in that they have not opted to have the appeal heard by the United States District Court for the District of Utah. *Id.* at § 158(c); 10th Cir. BAP L.R. 8001-1(a) and (d). The appeal was filed timely by the Debtor, and the bankruptcy court's Order is "final" within the meaning of § 158(a)(1). *See* Fed. R. Bankr. P. 8001-8002.

III. Standard of Review.

The Bankruptcy Appellate Panel may affirm, modify, or reverse a

¹ Future references are to Title 11 of the United States Code, unless noted otherwise.

² The Chapter 12 Plan of John V. Francks Turkey Co., Inc., was also confirmed at that time.

bankruptcy court's judgment, order, or decree or remand with instructions for further proceedings. Fed. R. Bankr. P. 8013. "For purposes of standard of review, decisions by judges are traditionally divided into three categories, denominated questions of law (reviewable de novo), questions of fact (reviewable for clear error), and matters of discretion (reviewable for 'abuse of discretion')." *Pierce v. Underwood*, 487 U.S. 552, 558 (1988).

IV. Discussion.

A chapter 12 case may be filed only by a family farmer with regular annual income. § 109(f). Section 101(18)(A) provides a four-part test for determining whether an individual or an individual and spouse qualify as a family farmer.³ The individual or individual and spouse must: 1) be engaged in a farming operation; 2) have aggregate debts not exceeding \$1,500,000; 3) have not less than 80% of his, her, or their noncontingent, liquidated debts on the date the case is filed (exclusive of debt for a principal residence unless the debt arises out of a farming operation) arise out of a farming operation owned or operated by such individual or individual and spouse; and 4) have received from such operation more than 50% of such individual's or such individual and spouse's gross income for the taxable year preceding the taxable year in which the chapter 12 case is

³ Section 101(18)(A) reads as follows:

"[F]amily farmer" means--

(A) individual or individual and spouse engaged in a farming operation whose aggregate debts do not exceed \$1,500,000 and not less than 80 percent of whose aggregate noncontingent, liquidated debts (excluding a debt for the principal residence of such individual or such individual and spouse unless such debt arises out of a farming operation), on the date the case is filed, arise out of a farming operation owned or operated by such individual or such individual and spouse, and such individual or such individual and spouse receive from such farming operation more than 50 percent of such individual's or such individual and spouse's gross income for the taxable year preceding the taxable year in which the case concerning such individual or such individual and spouse was filed

filed. Each one of these four elements must be satisfied for an individual or an individual and spouse to qualify as a family farmer; the Bank takes issue with the first and the fourth. We begin our analysis with the fourth requirement involving gross income.

The fourth requirement for an individual to qualify as a family farmer is known as the "farm income test." Under this test, the debtor must have received from the debtor's farming operation more than 50% of the debtor's gross income during the taxable year immediately preceding the taxable year in which the case is filed. Analyzing whether a debtor has satisfied the farm income test is a two-step process. The first step is to determine the amount of the debtor's gross income during the relevant tax year. The second step is to determine how much of that gross income was received from the debtor's farming operation. The bankruptcy court found that the Debtors satisfied the farm income test, based on the fact that the loan obtained from Moroni Feed Credit Union, which was secured by water stock owned by the farm corporation, constitutes farm income.

We first analyze the amount of the Debtors' gross income during the tax year 1997.⁴ The Code does not contain a definition of the term "gross income" and does not indicate whether the term was intended to be interpreted in accordance with the Internal Revenue Code or in some other fashion. The Seventh Circuit has held that gross income should be interpreted in accordance with the Internal Revenue Code. *In re Wagner*, 808 F.2d 542 (7th Cir. 1986). In *Wagner*, the court considered whether income which the debtor received as a distribution from his individual retirement account should be included as part of the debtor's gross income in determining whether the debtor was a "farmer" and

⁴ We note that it is not entirely clear whether the loan was received in 1997. The Debtors' schedules indicate that the loan was incurred in 1996. Their testimony, however, was that the proceeds were used for living expenses in 1997.

thus exempt from involuntary bankruptcy under § 303(a).⁵ The court held that the Internal Revenue Code definition should be applied and, accordingly, that the withdrawal must be included in the debtor's gross income for the year. The basis for the court's decision was that the Internal Revenue Code definition provided the parties and the courts with a specific and predictable test and that such a test was consistent with Congress's use of an objective standard for determining who is a farmer for bankruptcy purposes. *Id.* at 548.

Many courts have followed *Wagner* in utilizing the tax code definition of gross income to determine eligibility as a family farmer under Chapter 12. *See In re Grey*, 145 B.R. 86, 87 (Bankr. D. Kan. 1992); *In re Vernon*, 101 B.R. 87 (Bankr. E.D. Mo. 1989); *In re Bergman*, 78 B.R. 911 (Bankr. S.D. Ill. 1987). While some of these courts have espoused a rule of strict adherence to tax return declarations of income (*see, e.g., In re Nelson*, 73 B.R. 363 (Bankr. D. Kan. 1987)), other courts have cautioned that a strict tax code approach should be modified or abandoned in those cases in which a tax code solution would be "absurdly irreconcilable" with the Chapter 12 statutory provisions and legislative history. *In re Faber*, 78 B.R. 934, 935 (Bankr. S.D. Iowa 1987); *see In re Way*, 120 B.R. 81 (Bankr. S.D. Tex. 1990).

The *Wagner* approach was rejected by the bankruptcy court in *In re Rott*, 73 B.R. 366 (Bankr. D.N.D. 1987), which held that it would analyze gross income on a case-by-case basis and not be bound by the Internal Revenue Code definition. In *Rott*, a creditor argued that forgiveness of indebtedness, which is considered income under the Internal Revenue Code, must be included in calculating the amount of the debtor's gross income for purposes of Chapter 12 eligibility. The court declined to follow *Wagner*, and did not include the debt

⁵ Although *Wagner* considered the definition of "farmer" rather than "family farmer," both definitions contain an identical gross income test and the reasoning of *Wagner* is equally applicable to the definition of family farmer.

forgiveness as income.

While we are not in total disagreement with the flexible approach adopted by *Rott*, we find the more persuasive line of reasoning to be that of the court in *Wagner*. As the court in *Wagner* concluded, a simple and clear interpretation of income is best, and is most easily done by deeming § 101(18) to incorporate the definition of gross income in federal income tax law. *Wagner*, 808 F.2d at 549.

For purposes of this case, we need describe only the broad outlines of the relevant tax principles.⁶ An economic gain is gross income when its recipient has such control over it that, as a practical matter, he derives readily realizable economic value from it. *Rutkin v. United States*, 343 U.S. 130 (1952). A loan does not in itself constitute income to the borrower because whatever temporary economic benefit he derives from the use of the funds is offset by the corresponding obligation to repay them. *See James v. United States*, 366 U.S. 213, 219 (1961); *United States v. Rochelle*, 384 F.2d 748, 751 (5th Cir. 1967).

In this case, there is no question that the funds obtained were a loan and created a debtor-creditor relationship between the Debtors and Moroni Feed Credit Union. The Debtors listed the loan as a secured obligation in their schedules. The fact that the Debtors used the loan proceeds for living expenses in place of salary is offset by their obligation to repay Moroni Feed Credit Union.

The Debtors urge the Court to accept a "bootstrap" argument--that since their Plan calls for them to liquidate farm assets, i.e., water stock, to repay the loan to Moroni Feed Credit Union, the loan should qualify as farm income. We reject this argument, however, on the grounds that eligibility is a threshold matter and cannot be granted on a provisional basis; eligibility must be determined at

⁶ 26 C.F.R. § 1.61-1 provides in relevant part:

(a) . . . Gross income means all income from whatever source derived, unless excluded by law. Gross income includes income realized in any form, whether in money, property, or services

the outset of the case. *See Grey*, 145 B.R. at 87. Further, this argument goes to the second element of the farm income test, i.e., whether the income in question was received from the debtor's farm operation. Because we hold the loan proceeds do not constitute income, we do not reach the second element of the test.⁷

Accordingly, we conclude that the bankruptcy court's finding that the Debtors had met the farm income test by including the loan as income is clearly erroneous. The Debtors are ineligible to proceed in this Chapter 12 proceeding because, when they filed their petition in 1998, they had received no farm income in the 1997 tax year.⁸ The Court need not consider the other grounds for reversal raised by the Bank on appeal.

V. Conclusion.

For the foregoing reasons, the decision of the bankruptcy court confirming the Debtors' Chapter 12 Plan is REVERSED AND REMANDED for proceedings consistent with this order and judgment.

⁷ Even if the loan proceeds were income, it is unlikely that it would be considered farm-related, since the collateral was water stock rather than livestock or farm equipment. *See, e.g., Armstrong v. Corn Belt Bank (In re Armstrong)*, 812 F.2d 1024 (7th Cir. 1987) (proceeds of sale of farm equipment constitutes farm income; however, lease income is not farm income when the rent is paid in cash and up front because the lessor does not bear the traditional risks of farming).

⁸ The Court recognizes that the result of its decision is harsh; often, the year preceding bankruptcy is financially disastrous for many family farmers. In recognition of this, legislation is pending that would amend § 101(18) to expand the relevant time period from the taxable year preceding the bankruptcy filing to "at least 1 of the 3 taxable years preceding the taxable year." Safeguarding America's Farms Entering the Year 2000 Act, S. 260, 106th Cong. (1999).